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IN THE

Supreme Court of the United States

OCTOBER TERM 1948

No. 410

TRICO PRODUCTS CORPORATION,
Petitioner,

v.

GEORGE T. MCGOWAN, Collector of Internal Revenue for the Twenty-eighth District of New York,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

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of Counsel.

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CASES CITED

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To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Trico Products Corporation prays that a writ of certiorari be issued to review the judgment of the United States Circuit Court of Appeals for the Second Circuit (now United States Court of Appeals for the Second Circuit), entered July 21, 1948, which affirmed the judgment entered September 16, 1946 by the United States District Court for the Western District of New York (R. 910) dismissing petitioner's complaint in an action to secure a refund of Federal income taxes for the years 1936 and 1937 in the aggregate amount, with interest, of $1,540,154.79, assessed under Section 102 of the Revenue Act of 1936.

Opinions Below

The opinion of the Circuit Court of Appeals is reported at 169 F. 2d 343. The opinion of the District Court is reported at 67 F. Supp. 311.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered July 21, 1948. A petition for rehearing was filed on August 5, 1948 and was denied by order entered August 17, 1948.

Jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended (28 U. S. C. A. §347-a).

Statute Involved

Section 102 of the Revenue Act of 1936 (49 Stat. 1676), so far as here relevant, provides:

> "Sec. 102. *Surtax on Corporations Improperly Accumulating Surplus.*
>
> (a) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed—
>
> (1) In the case of corporations not subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:
>
> 25 per centum of the amount of the retained net income not in excess of $100,000, plus

35 per centum of the amount of the retained net income in excess of $100,000.

(2) In the case of corporations subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

15 per centum of the amount of the retained net income not in excess of $100,000, plus

25 per centum of the amount of the retained net income in excess of $100,000.

(b) *Prima Facie Evidence.*—The fact that any corporation is a mere holding or investment company or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders."

Respondent concedes that petitioner was not formed for the prohibited purpose (R. 153), and is not a mere holding or investment company (R. 898). Petitioner, organized in 1920 (R. 90), has at all times been an active industrial enterprise engaged primarily in the manufacture and sale of patented automatic windshield wipers to the automotive industry. In the tax years in question, it had over 2,000 stockholders (R. 5, 10).

Summary Statement of Matter Involved

A.

The heavy penalty assessments made in this case are primarily the result of an erroneous refusal by the courts below to take into account recapitalization agreements entered into in good faith in 1927 between petitioner's then stockholders and a group of investment bankers, and between petitioner and its stockholders, in connection with the public sale by the stockholders of a portion of their stock (Ex. P-10, R. 552). By the terms of those agreements, which are more particularly described below (pp.

9 *et seq.*), the stock retained by petitioner's stockholders was a deferred stock subject to an annual waiver of dividends up to $2.50 per share from which it could be released, in installments, only as petitioner's earnings attained certain levels. The courts below acknowledged that in conserving petitioner's earnings, the principal stockholders were motivated by the contract purpose to build up petitioner's capital to increase earnings and thus secure the release of the deferred shares, and that that purpose was not a surtax-saving purpose; but excluded consideration of that motive on the ground that the carrying out of the agreements "satisfied no business need of the Corporation." The courts below thus held that facts disproving the existence of surtax-saving motives are not material in the determination of liability under Section 102 if those facts relate to the individual motives of the controlling stockholders rather than to the business needs of the Corporation.

On the subject of the 1927 recapitalization agreements, the District Court said (R. 870):

> "'Petitioner urges as its principal contention that it was a reasonable need of the business to build up an invested capital which, by increasing total earnings, would enable the controlling stockholders to release a larger amount of stock from the restriction originally placed upon it. This may have been a natural course for the majority of the stockholders to cause the corporation to adopt for their own private ends, but it had nothing to do with the needs of the business * * *'".

In its findings the District Court stated (R. 903-4):

> "26. The use of the accumulated earnings and profits to build up invested capital thus increasing the earnings and thereby securing the release of additional shares of restricted stock was not a factor connected with the reasonable needs of the plaintiff's business. While the release of these restricted shares was beneficial to the majority and controlling stockholders, they were of corresponding detriment to the minority and

remaining stockholders. The satisfying of the financial interests of only a part of the stockholders is not the satisfying of a business need of a corporation within the provisions of Section 102, Revenue Act of 1936."

The District Court's view of the 1927 recapitalization agreements was adopted by the Circuit Court of Appeals, whose only statements regarding the agreements were as follows:

> "The reasons advanced by the appellant for keeping so large a surplus are (a) the 1927 Recapitalization Agreements, (b) the maintaining of its position in the industry, and (c) the necessity to preserve its capital and to diversify its products because the basic patents on its vacuum-operated windshield wiper would expire in 1942. These reasons were considered by the district judge and we are not convinced that his rejection of each and all of them as justification for the large accumulations was erroneous. The conservation of earnings in order to be able to release the restricted stock under the 1927 agreements would be beneficial to the holders of such stock but satisfied no business need of the corporation."

In the statements quoted above it was acknowledged that the controlling stockholders were motivated by a desire to carry out the recapitalization agreements. It has never been claimed, and could not be claimed, that those agreements were entered into with surtax-saving motives. The motive of obtaining the release of the restricted stock, referred to and acknowledged by the courts below, was the opposite of a surtax-saving motive because it enabled the holders of the stock to receive dividends of $2.50 a share not previously payable on that stock. As a result of the conservation of earnings and building up of the Company, a total of 261,360 shares of stock were ultimately released from dividend restrictions, including 89,960 shares released in the tax years here involved (Ex. P-26, R. 624). As the number of released shares increased, the aggregate of the regular $2.50 dividends payable on such shares to the stockholders here accused of avoiding surtaxes correspondingly

increased, rising from $123,650 in 1928 to $562,500 in 1936 and $599,877.50 in 1937 (Ex. P-19, R. 612). During the period from 1928 through 1944 the regular $2.50 dividends paid to the controlling stockholders on the formerly restricted stock aggregated more than $8,200,000 (Ex. P-19, R. 612).

While acknowledging that the controlling stockholders were motivated by a purpose to carry out the 1927 recapitalization agreements, the courts below nevertheless regarded the existence of such a non-surtax saving purpose as immaterial, variously stating their reasons as being that "This may have been a natural course for the majority of the stockholders to cause the Corporation to adopt for their own private ends, but it had nothing to do with the needs of the business" (R. 870); that "The satisfying of the financial interests of only a part of the stockholders is not the satisfying of a business need of a corporation within the provisions of Section 102, Revenue Act of 1936" (R. 903-4); and that the release of "the restricted stock under the 1927 agreements would be beneficial to the holders of such stock but satisfied no business need of the Corporation" (C. C. A. Opinion).

The courts below in effect treated Section 102 as predicating liability on accumulations deemed by the Commissioner and the court to be beyond ordinary business needs, regardless of a showing by independent evidence that the actual purpose or motive was not the avoidance of surtaxes. To be sure, the District Court, after determining that earnings had been accumulated beyond ordinary business needs, purported to make a further inquiry as to whether the resulting presumption had been overcome (R. 884), but since the independent evidence on that score had already been ruled out on the ground that it had nothing to do with the needs of the business, the Court readily found that the presumption had not been overcome.

The sole question under Section 102 is whether the prohibited purpose existed. The penalty cannot be applied where the actual purpose was not the prohibited purpose,

regardless of any question of business needs or whether the actual purpose had any relation to those needs. In the present case, proof of actual purpose was supplied by the recapitalization agreements of 1927; and the courts below were clearly in error in excluding those agreements from consideration on the ground that they had nothing to do with the needs of the business.

B.

Petitioner's business was dependent on patents on the automatic windshield wiper which were to expire in 1942 (R. 264, 433). Under the 1927 agreements, petitioner was precluded from obtaining capital for the promotion of additional products from any source other than conserved earnings (Ex. P-10, R. 563), and petitioner in 1935 therefore commenced making transfers from surplus to capital, earmarking such funds "for anticipated diversification of company's product on account of expiration of patents beginning year 1942" (R. 223), and so advising stockholders (Ex. P-36, R. 635).

Starting in 1931, and prior to the tax years in question, petitioner introduced in the automobile accessory market various vacuum-operated products designed to diversify its business, but did not succeed in developing a major product (R. 225-9). However, subsequent to the tax years involved, and as a culmination of the program undertaken in 1931, petitioner completed the development of a successful new product known as the Lift-O-Matic, the manufacturing and marketing of which, as the undisputed evidence showed, required expenditure of petitioner's entire capital resources (R. 266-81).

With respect to the diversification program, the Circuit Court of Appeals said:

> "At the time of the trial in December 1945, the appellant had developed a new product known as Lift-O-Matic which is a device for lowering or raising automobile windows by pushing an electric button. A very

> large expense is contemplated to bring this product into production. But there is no evidence that during the tax years in suit the appellant foresaw the need of any substantial expenditures for the development of this device, of which the earliest form had not progressed to the stage of a working model until 1938."

The Court thus held that a company is precluded under Section 102 from carrying out a long-established program required for diversification of its products, merely because in the tax years in question the precise product and exact amount required to finance it were not definitely known. While that rule of law is particularly vulnerable in the case of petitioner, which was cut off from any source of capital other than retained earnings and was dependent on patents expiring at a known future date, the general legal principle laid down is such as to prevent any company facing inevitable future expenditures from providing therefor out of current earnings unless the future expenditures are precisely blueprinted or definitely budgeted in the tax year in question. The prohibition would apply even where (1) the necessity of conservation is evident from outward, concrete, provable facts and contemporaneous circumstances, and where (2) the very nature of the problem precludes precise blueprinting or budgeting. We submit that this is a wholly unwarranted and erroneous interpretation of Section 102.

Questions Presented

1. In determining the applicability of Section 102 of the Revenue Act of 1936, can evidence as to non-surtax saving purposes properly be excluded from consideration on the ground that the carrying out of those purposes satisfied no business need of the corporation?

2. Does Section 102 prevent the conservation of current earnings to meet known and provable future contingencies and exigencies, pursuant to a program of internal corporate financing established long before the tax year involved, simply because the ultimate expenditure of the funds cannot be precisely blueprinted or definitely budgeted in the tax year in question?

Facts

A. Provisions of 1927 Recapitalization Agreements

In 1927 petitioner had but 21 stockholders (Ex. D-1, R. 668). They were approached by investment bankers who offered them an opportunity to dispose immediately of a part of their interest in the Company provided they were willing to agree to certain terms, including temporary restrictions on the remainder of their holdings (R. 120-9). Negotiations resulted in contracts entered into simultaneously in September, 1927, between (1) the bankers and all the stockholders (Ex. P-10, R. 552) and (2) between all the stockholders and petitioner (Ex. P-10, R. 560). Pursuant to those contracts petitioner was recapitalized so that its capital structure consisted solely of 675,000 shares of no par common stock issued to the original stockholders in lieu of stock previously held by them. The 675,000 shares were divided into 225,000 shares of so-called "free" stock and 450,000 shares of so-called "deferred" stock. The stockholders sold 175,000 shares of the free stock at $25 a share to the bankers who resold those shares to the public at $31 per share, or a total of $5,425,000. At that time the Company's net tangible assets were only $1,800,000 (less than $3 per share) (Ex. P-11, R. 580-1), its principal assets being valuable adjudicated patents on an automatic windshield wiper which had fifteen remaining years of life and were carried on the books at the nominal value of $1 (R. 448). Earnings in 1927 were $1,372,000—about $2 per share (Ex. P-4, R. 526).

As a condition to the sale the bankers insisted upon two vital provisions in the agreement required to be entered into between petitioner and all of its stockholders: (1) The holders of the 450,000 deferred shares waived dividends thereon up to $2.50 per year (R. 560-1), subject to release from such waiver as hereinafter described, and (2) The stockholders and petitioner agreed that until all of the 450,000 shares of deferred stock were released from the dividend waiver the Company would not voluntarily liquidate nor make any change in capitalization which might impair the preferential right of the free shares (R. 563). The latter provision prevented the Company from obtaining additional capital through the issuance of preferred stock or bonds or any other source except conservation of earnings (R. 130-1, 139, 235, 238, 326).

Pending release from the dividend waiver, the deferred shares were required to be placed in a voting trust agreement (R. 565). They were in effect dead assets—not entitled to dividends up to $2.50 and for all practical purposes unmarketable.

The deferred shares were releasable, however, on a graduated scale of earnings. For that purpose, the deferred shares were divided into three blocks—two blocks of 112,500 each, and one block of 225,000. The formula for release is set forth in the record (R. 561-2). Suffice it to say that in any single year earnings of $1,687,500 were required to release all the shares in the first block of 112,500 deferred shares, $2,700,000 to release the entire second block of 112,500 deferred shares, and $4,050,009 to release the first share and $6,075,000 to release the last share in the final block of 225,000 deferred shares (Ex. P-26, R. 624).

The recapitalization agreements unequivocably specified that they were entered into "In consideration * * * of the conservation of earnings and working capital which this agreement contemplates for the Company" (Ex. P-10, R. 560).

Petitioner does not claim that the recapitalization agreements prevented it as a matter of law from declaring dividends in excess of $2.50 a share on the free shares. While

it was intended that dividends should be so limited, and the agreements were instinct with an obligation to follow that course, it was necessary to include an escape clause in the event that some unforeseen contingency should arise making the declaration of additional dividends advisable. It was therefore provided in the contracts that in the event dividends in excess of $2.50 were declared in any calendar year, such dividends should be "declared and paid ratably share for share upon the entire 675,000 shares of new common stock". Such a contingency did arise in the very tax years in question in the form of the Undistributed Profits Tax (later recognized to be economically unsound and repealed), and dividends in excess of $2.50 per share were declared in those years as a result of the compulsion arising from such tax (R. 254).

The precise legal effect of the recapitalization agreements is not the question under Section 102. The question under Section 102 is the purpose, motive or state of mind of the controlling stockholders. On that question, the recapitalization agreements constitute the most direct and compelling evidence that could well be imagined. Whatever may be the legally enforceable effect of the agreements, there can be no question that the clear intention of the parties was to limit dividends to $2.50 a share until all the deferred shares were released, and that the purpose of that limitation had nothing whatever to do with the saving of surtaxes (R. 237-8, 240, 243, 128). The agreements, as stated above, provided that they were made "in consideration of the conservation of earnings and working capital for the Company", and the carrying out of that provision was vital to the Company, to the public holders of the free shares represented by the bankers and to the controlling stockholders as owners of the deferred shares.

The "conservation of earnings" provision affected those parties as follows:

1. *The Company.* In order to prevent any obligation of the Company being placed ahead of the prefer-

ential rights of the free shares, the bankers, as stated above, required the Company and the stockholders to agree that there would be no change in the Company's capitalization until all the deferred shares were released. The result was to cut the Company off from all the ordinary outside sources of capital and require it to rely exclusively on conserved earnings, which meant that its capital had to be built up steadily from that source because any present or future large requirement could not be met on short notice through the issuance of stocks, bonds or other long-term commitments. The Company instead was to be financed through waived dividends, i.e., through the "conservation of earnings * * * for the Company" as provided in the contract.

2. *The public holders of the free shares.* The conservation of earnings was most vital to the protection of the holders of the free shares. It was their best guarantee of continued payment of the preferential $2.50 dividend (a return of 8% on the sale price of the stock). It was their only assurance that at the time of the expiration of the basic patents (which accounted for $28 of the $31 value attached to their shares at the beginning) the Company would not be a mere shell representing a capital value to them of only $3 a share rather than $31 a share. It was their only protection against watering of the issue by the release of deferred shares on the basis of earnings which, if immediately dissipated, would have diluted the interest of every free shareholder by both increasing the number of outstanding free shares and at the same time reducing the backing for the shares by distributing the converted patent value which originally stood behind the shares. Only by the conservation of the value of the expiring patents could the free shareholders be assured of an interest in a long-lived rather than a short-lived enterprise. Coupled with the provision against voluntary liquidation, such conservation assured them of a gradual building up of the book value of their shares toward the price paid for them.

3. *The holders of the deferred stock.* The holders of the deferred stock were required by the bankers to waive the annual $2.50 dividend on their shares, and

they were willing to do so in order to achieve their purpose of immediately cashing a part of their interest in the enterprise, thereby dividing the risk inherent in the exploitation of the Company's valuable patents, and of ultimately achieving dividend equality and marketability for the balance of their shares. However, it was not intended that all or any part of the 450,000 deferred shares should remain forever restricted as to dividends. The original stockholders would never have sold 26% of their stock on any such basis. To release the last share eventual earnings of $6,075,000 in one year were required, but that could be accomplished only by applying conserved earnings toward building up the Company, which had tangible assets of but $1,800,000 to begin with. It was not intended that the deferred shareholders should waive dividends on 450,000 shares and then turn around and immediately declare them on 675,000 shares. The deferred shareholders were not interested in receiving partial dividends at the expense of indefinitely postponing the receipt of equal dividends and marketable shares which would have a value when released of some $14,000,000 ($31 × 450,000 shares). The course planned, and actually followed, was to pay the same dividend ($2.50) on progressively more shares as they were released, rather than a larger dividend on a static number of shares.

The recapitalization agreements represented a sound and workable arrangement which thereafter operated to control petitioner's dividend policy, entirely without reference to any question of saving surtaxes. The agreements were fully explained at the trial by Thomas E. Wing, the attorney who represented the bankers in the negotiation and drafting of the agreements (R. 230-250, see particularly 242-3, 247-9). There can be no question that the agreements were intended to prevent the declaration of dividends in excess of $2.50 on the free shares, but that was to be accomplished by holding an incentive or club over the controlling stockholders, rather than by an express prohibition in the agreements. While the dividend limitation was primarily for the protection of the free

shareholders, the bankers astutely drafted the agreements so that the honoring of the limitation was compelled by the self-interest of the controlling stockholders. As Mr. Wing testified, "counsel for the Company and the bankers both did not conceive that it was necessary to put into any agreement a covenant by a party not to do something that is against his interest. It is implicit. It just is not done" (R. 248-9). Thus while there was no express provision prohibiting dividends in excess of $2.50 on the free shares, the contracts were so set up that such dividends could not be declared without thwarting every declared purpose of the parties and defeating the essential provisions of the contracts, including those provisions that were in the self-interest of the controlling stockholders.

The lower courts failed even to take notice of most of the legitimate contract purposes of conservation. They did take notice of the purpose of releasing the deferred stock, but brushed it aside on the ground that it was a purpose of the stockholders and "satisfied no business need of the Corporation." If it were to be assumed, as it may be for the purposes of this petition, that the lower courts were correct in saying that the carrying out of the agreements satisfied no business need of the Corporation, the fact remains that they erred in holding that evidence as to non-surtax saving purposes is irrelevant unless it relates to the business needs of the Corporation.

The Court stated that the release of the restricted stock "would be beneficial to the holders of such stock", but failed to recognize the significance of that statement. The release of the stock enabled the holders thereof to receive dividends of $2.50 a share not previously payable on that stock. Dividends in that category were in fact received in constantly increasing amounts, reaching an aggregate of $8,200,000 in the period from 1928 to 1944 (Ex. P-19, R. 612). The purpose of achieving that objective was not, therefore, a surtax-saving motive.

The holders of the deferred shares were the controlling stockholders, and since their purpose in conserving earn-

ings was to obtain the release of the stock and thereby receive dividends, the purpose of the conservation was not within the condemnation of Section 102. That is true whether that purpose be described as a business purpose, a selfish purpose or any other purpose. The Court erred in disregarding the evidence on the ground that it did not relate to the needs of the business. The sole question under the statute is purpose, and the presumption based on the needs of the business test is controlling only in the absence of direct, substantiated evidence as to actual purpose.

B. Operations under 1927 Recapitalization Agreements

Following the 1927 recapitalization petitioner's earnings gradually increased from $1,372,000 in 1927 to $4,225,000 in 1940 (Ex. P-4, R. 526, 528). As the earnings increased deferred shares were released, a total of 261,360 shares having been released up to 1944 (Ex. P-26, R. 624). The release of the remaining 188,640 shares of deferred stock is in sight as the result of the exploitation of the Lift-O-Matic device, provided the program is not choked off through the imposition of Section 102 assessments.

As the amount of free stock was increased, the aggregate amount of annual dividends increased. Dividends prior to 1927 had been extremely small. Dividends in 1927 aggregated $339,000 and thereafter increased to $686,000 in 1928, to $937,000 in 1931, and to more than $1,900,000 in each of the tax years in question (Ex. D-1, R. 647-8). The $2.50 dividend on the free shares was paid every year from 1928 through 1944, and additional dividends were paid under compulsion of the Undistributed Profits Tax in 1936 and 1937.

During the period 1928-1944 petitioner paid its stockholders a total of $18,668,000 in cash dividends, and paid out more than $42,000,000 in wages and $20,000,000 in taxes (exclusive of Section 102 taxes) (Ex. P-27, R. 624). All of that was accomplished by a Company which started in 1927 with tangible assets of only $1,800,000.

What success petitioner enjoyed was due to the fact that it achieved the unique position of sole supplier of windshield wipers to the entire automobile industry. That position was achieved in spite of the fact that the industry is and has always been reluctant to place itself in a position where its huge assembly lines are dependent on a single source of supply. In fact, in the entire history of the industry, petitioner is the only company that has ever achieved, much less retained, a sole supplier position (R. 115, 194, 439).

On three occasions prior to the tax years in question petitioner was on the verge of losing its sole supplier status, but it was able to survive because of its patent position and because of its financial strength derived from the established and continuing conservation policy provided for under the 1927 agreements (R. 159-183, 195-217).

Although petitioner succeeded in retaining its business up to the time of the tax years in question, it was in the meantime faced with two definite and known facts—(1) that its basic patents would inevitably expire in 1942, and (2) that under the contract prohibition against outside sources of capital it could look only to conserved earnings for financing any diversification of its business. To meet the situation, petitioner did two things. Starting prior to 1931, it inaugurated an intensive program of research and experimentation in an effort to develop new products. Secondly, pursuant to a resolution adopted in 1934 (Ex. P-31, R. 629, 403-5), long before any question was raised under Section 102*, petitioner on advice of its accountants, Price, Waterhouse & Co., commenced making transfers from surplus to capital, earmarking such funds "for anticipated diversification of Company's product on account of expirations of patents beginning year 1942", and so advising

* Section 102 assessments were first proposed by the Revenue Agent in Charge in 1936 and assessed in 1937, for the tax years 1934-1935.

stockholders (Ex. P-36, R. 635). By 1944, a total of $11,-500,000 had been set aside for that purpose (R. 260).

Petitioner succeeded prior to the tax years in question in developing a number of products which displayed great promise when introduced, but for one reason or another, as explained in the testimony (R. 225-9), demand disappeared and it came to be recognized that they could not be counted upon as major products. However, shortly after the tax years in question petitioner finally found a new product which has proved successful—the Lift-O-Matic, a mechanism for raising and lowering car windows by the touch of a button, the motor of which employs the same source of power as the windshield wiper, namely, the vacuum produced by the running of the automobile engine. Sixteen million dollars, practically all of petitioner's available capital, was shown to be required to get production of the Lift-O-Matic underway (R. 275-281).

Evidence of product diversification was ignored by the lower courts on the ground that Lift-O-Matic was not an actual device in being in the tax years involved. But as we have shown, while the Lift-O-Matic device did not come to final fruition until after the tax years in question, it marked the culmination of a required program of product diversification undertaken long before those years, the funds for which had been specifically segregated and earmarked by petitioner's directors. It is not the fact that such long-range planning is precluded by Section 102; and the lower courts' holding extends the statute far beyond its intended application.

C. Facts more particularly relating to tax years in question, 1936-1937

Petitioner's net income in 1936 was $4,180,000 and in 1937 was $3,790,000 (Ex. P-4, R. 527). In the former year it distributed $2,210,000, or 52.8% of its net income, in cash dividends, and in the latter year $1,960,000, or 51.7% of its net income (Ex. P-21, R. 614).

During the two years in question petitioner expended $2,436,000 for plant and equipment, increased its inventories by $876,000 and expended $1,207,000 in purchases of Treasury stock in order to have such stock available for delivery to its largest customer, General Motors Corporation, under a profit sharing agreement giving petitioner an option to make payments to General Motors in either cash or free stock (R. 254-5, Ex. P-3; R. 524, Ex. P-17; R. 601-6). Considering the two years together, out of aggregate earnings of slightly less than $8,000,000, the items of dividends and expenditures for plant and equipment alone accounted for $6,600,000, and adding the expenditures for Treasury stock (which even without reference to the business reasons therefor could not be regarded as an accumulation of earnings or profits under Section 102—*Bruckheimer* v. *Commissioner*, 46 BTA 234, 239-40) all but $161,267.45 of the total earnings are accounted for.

Petitioner's so-called "accumulated earnings" amounted to $10,913,000 at the end of 1936 and $12,745,000 at the end of 1937 (Ex. P-3, R. 524). However, those figures include all earnings ploughed back into productive facilities. At the end of 1936 and 1937 the ratio of petitioner's current assets to current liabilities was less than 3.7 to 1, including in current assets the funds set aside for diversification of products (Ex. P-3, R. 524). The average ratio of current assets to current liabilities in the automobile parts industry was 3.8 to 1 in 1936 and 4.4 to 1 in 1937 (Harold G. Moulton, et al., *Capital Expansion, Employment and Economic Stability*—The Brookings Institute, Washington, D. C., 1940—pp. 386-7, 375).

Reasons for Granting the Writ

The Circuit Court of Appeals has decided important questions of federal law which have not, but should be, settled by this Court.

The case is, of course, of vital importance to petitioner. Section 102 taxes assessed or officially proposed for the years 1934 through 1942 amount with interest to more than \$9,000,000 (Ex. P-28, R. 626) and additional assessments have been proposed for the tax years 1943, 1944 and 1945. The effect of these assessments on a company such as petitioner, whose combined capital and surplus at the end of 1944 was approximately \$17,000,000 (Ex. P-3, R. 525), is devastating, and represents a grave threat to its existence. In addition, the denial of the right to complete the performance of the recapitalization agreements amounts to a virtual confiscation of the vested contract and property rights of the holders of the remaining deferred shares, and at the same time jeopardizes the interests of the other parties to the agreements, particularly in view of the Company's inability to procure capital from outside sources as long as any of the deferred shares remain outstanding.

Of perhaps greater importance, as far as this Court is concerned, is the effect of the decision on other business enterprises in the country.

A great many corporations have entered into contracts either with their stockholders or with financial institutions which restrict in some fashion the dividends that can be declared by the corporation. If those contracts are to be disregarded in determining liability under Section 102, then those corporations will be subject to possible federal tax liability for performing common-law obligations under contract.

Many other corporations face the problem of planning for future needs and exigencies. In many cases it is impossible to lay down an exact blueprint or budget for the meeting of needs that are known but are not subject to precise measurement. Directors may be perfectly justified in their judgment that a conservation of part of their company's earnings is reasonable and prudent, but under the tests laid down by the Courts below are not free to make provision for such future needs. The result can only be to hamstring the discretion of directors and to stifle business progress.

It is no overstatement to say that directly as a result of the decisions involving petitioner, Section 102 is and has been causing greater concern to corporate managements than any other provision in the tax laws today. Widespread consternation and uncertainty have resulted from administrative extension of the intended application of the statute, whereby the statute has been converted into a tax on accumulations allegedly beyond needs of the business, regardless of actual motive, with no satisfactory measuring stick and with resulting potential liability not only of corporations for the penalty tax but also of directors for alleged mismanagement claims by minority stockholders.

Originally devised for use only against so-called "incorporated pocketbooks", the statute in petitioner's case was for the first time applied to an active business corporation with hundreds of stockholders, and the decision has been used by the Revenue Department as a threat to compel the dissipation of needed working capital in literally thousands of cases where management could not be sure that the Commissioner or the courts would agree with their business judgment. The seriousness of the situation is increased by the simultaneous drying up of sources of equity and venture capital, thereby making increases in productive capacity more dependent than ever on retained earnings.

The peculiar reasoning of the District Court in the present case has added to the bewilderment caused by the decision itself. Thus the District Court, in what was characterized by the Circuit Court of Appeals as a "carefully considered opinion", stated (R. 878):

> "Whether the two Trico directors were interested or disinterested or men of high character does not determine the question at issue. Disinterested directors may be more conservative than the statute permits."

At another point, the Court stated (R. 883):

> "This case exhibits the old conflict between public and private finance. The Government always needs

money and in recent years has needed very much money. To meet this need in part, Congress enacted the Revenue Act of 1936. Plaintiff, on the other hand has consistently pursued a policy of conservation of earnings. If this policy has conflicted with the Act, the latter must prevail."

At still another point (R. 891):

> "There is no proof that the retention of the 1936 and 1937 taxes paid by plaintiff to the Government has or will impede its progress or deprive it of 'the opportunity to fulfill its destiny', which plaintiff asks. The matters involved in this lawsuit are a decade old. Since then plaintiff has prospered. It has paid its taxes to the Government and will not have to pay them again. It may have had good reasons to pursue a conservative policy during its years of struggle and may now think that such a policy is necessary to exploit its Lift-O-Matic but when this policy conflicts with the fiscal policy of Congress, the latter must prevail."

The widespread and unsettling effect of the threat posed by the present interpretation of Section 102 is evidenced by the mass of literature on the subject, ranging from articles pointing out the uncertainties in the administration of the statute and warning that directors must act at their peril, to proposals for legislative clarification or revision of the statute. A bibliography is set forth in the Appendix hereto which is far from complete but will give some idea of the concern being shown over the administration of the statute.

The Department of Commerce has attempted to allay the fears of businessmen to some extent. For instance, in an official press release of the Department of Commerce (No. 15,643, March 19, 1948), the Secretary of Commerce stated that "the businessman's reaction to Section 102 has, in many cases, been unnecessarily fearful", and that "It should be understood that the surtaxes under Section 102 will apply only when a corporation fails to distribute its profits for the purpose of preventing the imposition of personal surtaxes upon its shareholders."

Assurances by the Department of Commerce, albeit well intended, are of little comfort in the face of action by the Bureau of Internal Revenue. What is required to settle the matter is an authoritative pronouncement by this Court. The only cases in which this Court has ruled on Section 102 were two cases involving corporations each having but one stockholder to whom large non-taxable loans were made in lieu of dividends (*Helvering* v. *Chicago Stock Yards Co.*, 318 U. S. 693; *Helvering* v. *National Grocery Co.*, 304 U. S. 282). Since those rulings were made, and largely as a result of the decisions in the Trico cases, Section 102 has become a national issue. A decision by this Court is required to undo an injustice to petitioner and to remove the cloud hanging over industry as a result of the administrative extension of Section 102 beyond its intended application.

The questions here presented have not been ruled upon by this Court. While the Court denied petitioner's application for a writ of certiorari in another case, *Trico Products Corporation* v. *Commissioner*, 320 U. S. 799, wherein the Circuit Court of Appeals affirmed a decision of the Board of Tax Appeals holding Trico liable for the Section 102 tax for the years 1934-1935, the questions of law raised by the Circuit Court's decision in that case were substantially different from those raised in this case. Furthermore, on the very day this Court denied the prior petition for a writ, it handed down its decision in *Dobson* v. *Commissioner*, 320 U. S. 489, in which it set forth the strict limitations on its power to review Tax Court decisions. Since the rule in the *Dobson* case has been eliminated by statute (Internal Revenue Code, § 1141a), and since in any event the present case originated in the District Court, the limitations on this Court's power to review which existed in the prior case do not exist here.

Conclusion

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

Articles Discussing Section 102 of the Internal Revenue Code

The list set forth below is by no means a complete bibliography of discussions of Section 102 during the years 1946-1948. It is intended only to indicate representative sources. As shown by the titles, many of the articles listed were devoted exclusively to Section 102; in all of the articles, the Section 102 problem was discussed.

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		GRAVES, HAROLD M. "Postwar Taxation and Economic Progress." New York, McGraw-Hill Book Co., Inc., 1946, pp. 43-49.
Jan.		*Taxes—The Tax Magazine* 24:24-32. HOLZMAN, ROBERT S. "Impact of the War's End on Section 102."
Feb.		National Industrial Conference Board. *The Conference Board Business Record* 3:84-88. LANDMAN, J. H. "Penalty for Improper Retention of Earnings."
Feb.	16	*Kiplinger Tax Letter* pp. 1-2.
Feb.	20-21	*New York Law Journal,* v. 115, WHITE, HAROLD B., "Tax Penalty on Unreasonable Accumulation of Corporate Earnings".
Mar.		*Journal of Accountancy* 81:200-205. GOODMAN, MORRIS. "Section 102—A Postwar Tax Problem."
Apr.		*Taxes—The Tax Magazine* 24:330-339. SIMONS, GUSTAVE. "Modern Techniques in the Practice of Tax Law"—Analysis of Section 102.
Apr.	12	*U. S. News* 20:62. "Penalty Taxes."
May		*American Economic Review* 36:241-279. "Postwar Tax Policy; Symposium."
May		NATIONAL ASSOCIATION OF MANUFACTURERS. RESEARCH DEPARTMENT. "Improper Accumulation of Surplus. (Section 102—Internal Revenue Code.)" New York, 13 pp.

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May 2	*Report for the Business Executive* No. 376:6-7. "Taxes—Penalty vs. Surtax."
May 10	*U. S. News* 20:59. "Section 102."
May 24	*U. S. News* 20:22-23. "Lever for Bigger Dividends: Tax Power Over Reserved Profit."
June 22	*Magazine of Wall Street* 78:319-330. COFFIN, H. S. "Where Tax Enforcement Means Higher Dividends, Affects Corporate Reserves."
July	*Taxes—The Tax Magazine* 24:656-658. BARRETT, RICHARD F. "The Section 102 Penalty."
July 11	Research Institute of America. Report For Management Control—*Taxation* 3:53-54. "Accumulated War Profits May Invite Penalty Tax."
Aug.	*Dun's Review* 54:18-20. LANDMAN, J. H. "Business' Next Tax Headache; Penalties on Retained Profits."
Aug.	*Taxes—The Tax Magazine* 24:746-750. COWAN, ALVIN RICHARD. "Taxability of Corporate Distributions of Earnings and Profits."
Sept. 1	*New York Times* Section III, pp. 1, 2. NELSON, GODFREY N. "Retained Earnings and Tax Discussed—Levies on Accumulated Profits Called Unsound, Uneconomic."
Sept. 13	*U. S. News* 21:57. "Scrutiny of Withheld Profits."
Sept. 21	*The Tax Barometer* v. 3, No. 43, Par. 435. "Some Notes on Unreasonable Accumulation of Surplus."
Oct.	LEAHY, JAMES L. "70% Distribution of Profits." 2d ed. Chicago, Commerce Clearing House, Inc.
Oct. 26	*Saturday Evening Post* 219:152. HANNA, P. "Even the Revenue Laws Favor Inflation; Section 102 of the U. S. Revenue Act."
Oct. 29	BUREAU OF NATIONAL AFFAIRS. WASHINGTON DAILY REPORTER SYSTEM. "What to Do About Section 102." A Special Report Prepared for Clientele by the Editor of the Daily Report for Executives. Washington Bureau of National Affairs. 7 pp. mimeo.
Oct. 31	Report for the Business Executive, pp. 5-6. "Taxes."

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Nov.		*Lybrand, Ross Brothers and Montgomery Journal* 27:9-16. "Dividend Policies in View of Section 102 of the Internal Revenue Code."
Nov.	1	*U. S. News* 21:50-51. "Inquiry Into Dividends."
Nov.	6	*New York Journal of Commerce* p. 4. "An Obsolete Penalty Tax."
Nov.	16	*Buffalo Evening News* p. 6. "New Tax Forms Ask Ratio of Earnings Paid in Dividends."
Nov.	18	*New York Journal of Commerce* p. 4. "Pressure for Dividends."
Nov.	27	Research Institute of America. Report for Management Control—*Taxation* 3:94-95. "New Angle on Corporate Earnings Question." "Radio Company Penalized for Undistributed Earnings."
Nov.	29	*New York Journal of Commerce* p. 4. "Why Dividends Are Large."
Dec.		*Buffalo Business* 21:62-69. Fichtner, C. C. "How Tax Changes Can Aid Business."
Dec.		*Controller* 14:660-663. Simon, A. Allen. "Corporate Surplus and Section 102 in the Postwar Period."
Dec.		*Pulling Together*. In the National Small Business Men's Association, p. 4. Tiffany, J. Raymond. "Depreciation Tax Rule Changed."
Dec.	6–7	Tarleau, Thomas N. "Effect of Section 102 Penalty on Current Accumulations of Corporate Earnings." (In: Tax Institute: "How Should Corporations Be Taxed?" By Ray G. Blakey and others. Symposium conducted by the Tax Institute, Dec. 6-7, 1946, New York. New York, Tax Institute, Inc., 1947. Chapter IX, pp. 111-129.)
Dec.	12	Research Institute of America. Report for Management Control. *Taxation* 3:98. "Last-Minute Warnings on Unreasonable Accumulations Surtax."
Dec.	20	*New York Journal of Commerce* p. 7. "Big Penalties Seen in Reserve Rises."
Dec.	21	*The Tax Barometer*. v. 4, No. 3, Par. 28. "Checklist of Deductions Available in Determining Applicability of Sec. 102."

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Dec. 24 *New York Journal of Commerce* p. 1. "Reserve Accumulations to Be Scrutinized—Excess Profits Clean Up."

Dec. 26 *Commercial & Financial Chronicle* 164:3353. RICHARDSON, M. E. "Penalty Tax on Retained Earnings."

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Jan. *New York Certified Public Accountant* 17:46-51. "Dividend Policies in View of Section 102 of the Internal Revenue Code."

Jan. 3 *New York Times* p. 27. "Tax Policy Called Threat to Credit."

Feb. *Taxes—The Tax Magazine* 25:101-110. HOLZMAN, R. S. "Corporation Income Tax. What's New in 102?"

Feb. 1 *Business Week* pp. 39-46. "Our Tax Structure: An Overhauling Job Needs to Be Done."

Feb. 5–6 MAGILL, ROSWELL. "What Business Wants in the Tax System." (In: American Management Association. *Financial Management Series No. 86*—"Current Problems in Financial Management." New York, American Management Association, 1947.) pp. 27-28.

Feb. 7 *New York Journal of Commerce* p. 4. "Perils in Section 102."

Mar. *Taxes—The Tax Magazine* 25:205-207. GRASKE, T. W. "Revising Tax Laws."

Mar. 19 *New York Jorunal of Commerce* pp. 5, 8. "Business Warned on Earnings Accumulation After Treasury's Sweep of Section 102 Cases."

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Mar.	21	*U. S. News* 22:48-49. "Scrutiny of Withheld Profits."
Mar.	31	*New York Journal of Commerce* p. 6. RIDDER, JOSEPH E. "Section 102 and Small Business."
Apr.		*Dun's Review* 55: sup. 7-34. GEORGE, E. B. & LANDRY, R. J. "Shadow of 102 on Dividend Policies, with Emphasis on the Immediate Tax Problems of Small Corporations."
Apr.	5	*Nation* 164:397. HUTCHINSON, K. "Undistributed Profits."
Apr.	8	*U. S. News* 22:48-49. "Rulings on Reserve of Corporations."
May	12	*New York Journal of Commerce,* "Revision of '102' is Held Needed."
May	16	*Tide* 21:46, 59. "Corporate Taxes."
May	26	*New York Journal of Commerce* p. 4. "Relief from Section 102."
June		*Tax Review,* published by Tax Foundation, 8:23-27. GEORGE, EDWIN B. & LANDRY, ROBERT J. "Some Economic Issues of Section 102."
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June	10	*New York Journal of Commerce* p. 1. "Taxes: Surtax Relief Remote."
June	16	*Barron's* 27:9. REEVES, J. P. "Corporate Undistributed Income on Spot."
June	21	BIGELOW, KENT, WILLARD & CO. "What to Do About Section 102?" A Brief Analysis. No. Imprint. 4 pp.
June	21	*The Tax Barometer* v. 4, No. 29, Par. 346. "Commissioner Loses Two Section 102 Cases."
June	30	*Babson's Washington Forecast* p. 3. "Taxes to Stay 'As Is'."
July	2	*Research Institute of America. Taxation Report* 4:99. "Bureau Again Tries to Force Dividend Distribution."
July	4	*U. S. News* 23:45. "Company Victory on Reserve Penalty."
July	5	*Kiplinger Tax Letter* p. 3. "Penalty Tax on Accumulations of Surplus."

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July	18	*U. S. News* 23:54. "When Reserves Tax Is Applied; Section 102 of the Internal Revenue Code."
July	19	*Kiplinger Tax Letter* p. 2.
Aug.	5	*New York Journal of Commerce* p. 1. "Taxes—Will Study Section 102."
Aug.	8	*U. S. News* 23:48-49. "Rulings on Reserve of Corporations."
Aug.	9	*NAM News* 15:4. "Federal Tax Structure Held Hindering Economic Growth."
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Oct.		Kilcullen, Richard. "Taxing Accumulation of Corporate Surplus Under Section 102." New York. Practicing Law Institute, 1947. (At head of title Federal Taxation Winter 1946 Supplement.)
Oct.		*Tax Law Review* 3:119-158. Lesser, J. K. & Holzman, R. S. "The '102' Cases."
Nov.		*Journal of Accountancy* 84:414-415. Lasser, J. K. "The Tax Clinic—Irving Baron on Section 102."
Nov.		*Pulling Together,* published by National Small Business Men's Association. pp. 3-4. "Some Reasons Why Small Business Sells Out to Large."
Nov.	4	U. S. House of Representatives. Committee on Ways and Means. "Revenue Revision, 1947-48, Reports of Special Tax Study Committee to Committee on Ways and Means, Nov. 4, 1947." Washington, U. S. Government Printing Office, 1947, pp. 16-17.
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Dec. 4 *New York Herald Tribune* p. 23. ". . . Twelve Forward Steps to Halt Inflation." (National Association of Manufacturers Advertisement.)

Dec. 8 *Wall Street Journal* p. 9. "Treasury Reassures Companies on Surplus Retained for Expansion."

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Dec. 19 *U. S. News* 23:62. "Calming of Fears Over Section 102."

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Feb.		*Vanderbilt Law Review* 1:227-241. NORVELL, W. E., JR. "Improper Accumulation of Surplus."
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Apr.	20	*New York Journal of Commerce* p. 1. "Tax Report—Congress Studies Easing Surtax on Retained Business Earnings."
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Aug. 14 — *Kiplinger Tax Letter* p. 2. "New Fears About the Section 102 Penalty Tax Are Plaguing Business."

Aug. 19 — *Iron Age* 162:158. "Trico Appeals Decision in Excess Profits Taxes."

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Oct. 23 — *NAM News* 16:2. "Small Business Group Proposes '102' Revision."